Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:POSTS-152061-01
AMHarbutte

date: November 13, 2001

to: Al Grundmeyer, Revenue Agent
LMSB Exam, Minneapolis, MN

from: ALICE M. HARBUTTE
Attorney (LMSB)

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subject: [redacted] Taxable Year

DISCLOSURE STATEMENT

This memorandum is in response to a request I received, as TEFRA Industry Counsel, from Ann Dario, TEFRA Coordinator, Area 9, regarding the above-referenced taxpayer. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

1. Whether the settlement reached by the Service and two partners during the audit of [redacted] for its [redacted] taxable year would preclude the Service from conducting an audit of the [redacted] U.S. Partnership Return filed by [redacted].

2. Which partners would be entitled to request consistent settlement, if any, with respect to the settlement between the Service and two partners of [redacted] for the partnership's [redacted] taxable year.

CONCLUSION

1. No. The Service is entitled to conduct a separate audit of [redacted]. While [redacted] was a partner of [redacted], each of these TEFRA partnerships filed separate partnership returns for the [redacted] taxable year. However, the partners of [redacted]

are entitled to request consistent settlement with respect to any settled partnership items of [redacted] under the provisions of I.R.C. § 6224(c)(2) which permits a request for consistent settlement to be submitted up to 150 days after the issuance of an FPAA.

2. Under section 6224(c), the Service is only authorized to settle partnership items, and must only offer consistent settlement terms to other partners if a partnership item is settled. See Prochorenko v. United States, 45 Fed. Cl. 494 (2000). [redacted], the source partnership reported, on its Form 1065, interest expense on investment debts in the amount of $[redacted]. [redacted], a partner in the source partnership, reported as its distributive share, $[redacted] in investment interest expense. The partners of [redacted] are indirect partners of [redacted]. Only one partnership item is at stake and it is a partnership item of the source partnership, [redacted], not [redacted]. For this reason, the same settlement terms must be offered to any other partner in [redacted], not just to its indirect partners through [redacted].

FACTS

[redacted]

[redacted] ("[redacted]"), is a TEFRA Partnership. For its [redacted] year it files a U.S. Partnership Return of Income, Form 1065. This return is marked as an "initial and final return." A copy of this return is attached as **Exhibit A.** The first page of the partnership return ([redacted]) is blank except for the signature line. The partnership reports on Schedule K, line 14a., as "Interest expense on investment debts" the amount of $[redacted]. Schedule K-1's are attached for the following three partners:

Partner 1: [redacted] (no TIN is provided for this entity);

Partner 2: [redacted]; and

Partner 3: [redacted] (no TIN is provided for

this entity).

No audit of the [redacted] Form 1065 of [redacted] has been commenced at this time. Exam would like to audit this partnership return. One item appearing on this return, however, has already been audited in another examination proceeding pertaining to [redacted]. This audit is discussed below. The relevant line item is found on the Schedule K-1 submitted with the [redacted] return for [redacted] ("[redacted]"). The [redacted] K-1, line 14a., allocates interest expense on investment notes to [redacted] in the amount of $[redacted].

[redacted] examination

[redacted] is also a TEFRA partnership. For its [redacted] taxable year it filed a U.S. Partnership Return of Income, Form 1065. A copy of this return is attached as **Exhibit B.** The Service has conducted and completed an audit of the [redacted] return of [redacted]. One item adjusted in this audit was the interest expense on investment debts. The amount reported was $[redacted]. During the audit this expense was adjusted by $[redacted]. The only other item adjusted was other income. The examiner's report "no-changed" tax-exempt interest income and distributions.

On [redacted], a 60-day letter was issued to the tax matters partner of [redacted] reflecting the proposed examination changes. A copy of this 60-day letter is attached as **Exhibit C.** As a result of the 60-day letter, two partners of [redacted] accepted the changes and executed settlement agreements. Copies of the settlement documents are attached as **Exhibit D.** In addition to these two settlement agreements, the TMP of [redacted] also signed a settlement agreement as TMP. This agreement is attached as **Exhibit E.** This settlement agreement executed by the TMP, however, is not binding on any notice partner. Since all other partners of [redacted] are notice partners, they are not bound by the agreement signed by the TMP; as it does not specifically state that the TMP is binding any notice partners. I.R.C. § 6224(c)(3). No FPAA has been issued to [redacted] for its [redacted] taxable year. Rather than issue an FPAA to [redacted], the Service would like to audit [redacted] for its [redacted] year and make any appropriate adjustments to partnership items of [redacted].

New audit:

The Service would like to conduct an audit of the [redacted] Form 1065 filed by [redacted]. One issue that the Service intends

to include in this audit is the interest expense on investment debts reported by [redacted] in the amount of $[redacted]. A question has arisen as to whether this would constitute a second audit and whether the partners of [redacted] could request consistent settlement under I.R.C. § 6224(c) if an FPAA is ultimately issued to [redacted].

DISCUSSION

Issue 1: Audit of [redacted]

I.R.C. §§ 7602 and 7605 prescribe the general rules concerning the manner, time and place for examining a taxpayer's return. Section 7602(a) states in pertinent part that:

> for the purpose of ascertaining the correctness of any return, ... determining the liability of any person for any internal revenue tax, ... or collecting such liability, the Secretary is authorized-
>
> > (1) to examine any books, papers, records, or other data which may be relevant or material to such inquiry; ....

Section 7605(b) places certain restrictions on taxpayers' examinations by requiring that:

> no taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless that taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

In Grossman v. Commissioner, 74 T.C. 1147, 1155-56 (1980), the Tax Court explained that this provision was designed to protect the taxpayer from onerous and unnecessarily frequent examinations and investigations of revenue agents.

There has been no audit conducted of the [redacted] Form 1065 filed by [redacted]. Section 7602 permits the Service to conduct an examination of this return. The examination that was conducted was with respect to a separate taxpayer, [redacted].

As a result, the provisions of I.R.C. § 7605(b) do not apply and no notice of any additional inspection needs to be sent.

Application of 6224(c) Consistent Settlement:

Section 6224(c)(2) provides, in relevant part:

> If the Secretary enters into a settlement agreement with any partner with respect to partnership items for any partnership taxable year, the Secretary shall offer to any other partner who so requests settlement terms for the partnership taxable year which are consistent with those contained in such settlement agreement.

Issue 2: Consistent Settlement

Your question is which partners would be entitled to request consistent settlement, if any, with respect to the settlement between the Service and two partners of [redacted] for the partnership's [redacted] taxable year.

Section 6224(c)(1) provides in relevant part that in the absence of a showing of fraud, malfeasance, or misrepresentation of fact, a settlement agreement between the Service and 1 or more partners in a partnership with respect to the determination of partnership items for any partnership tax year shall be binding on all parties to the agreement with respect to the determination of partnership items for the partnership tax year.

Section 6224(c)(2) provides, in relevant part, that if the Service enters into a settlement agreement with any partner with respect to partnership items for any partnership tax year, the Service must offer to any other partner who so requests settlement terms for the partnership tax year which are consistent with those contained in the settlement agreement.

Thus, under section 6224(c), the IRS is only authorized to settle partnership items, and must only offer consistent settlement terms to other partners if a partnership item is settled. See Prochorenko v. United States, 45 Fed. Cl. 494 (2000).

Partnership item:

The first issue is whether the Service, in the agreement at issue, settled a partnership item of the source partnership.

[redacted], the source partnership reported, on its Form 1065, interest expense on investment debts in the amount of $[redacted]. [redacted], a partner in the source partnership, reported as its distributive share, $[redacted] in investment interest expense.

[redacted] is also a TEFRA partnership. It filed a Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request" (AAR), to amend its return to reflect a portion of the investment interest expense as trade or business interest expense. The Service and [redacted] executed a Form 870-P in which the AAR amendment was accepted and a portion of the investment interest expense was recharacterized as trade or business interest expense.

Under section 6231(a)(3), a partnership item is any item more appropriately determined at the partnership level than at the partner level. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i) provides, in relevant part, that each partner's share of items of income, gain, loss, deduction or credit of the partnership are partnership items.

Under this definition, each partner's share of investment interest expense is a partnership item. See Saso v. Commissioner, 93 T.C. 730, 733-734 (1989). In the instant case, however, the Service and [redacted] agreed, not to the partner's share of investment interest expense, but to its characterization as trade or business interest expense.

Under Treas. Reg. § 301.6231(a)(3)-1(b), the legal and factual determinations underlying the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc., are partnership items. Investment interest means interest which is paid or accrued on indebtedness properly allocable to property held for investment. I.R.C. § 163(d)(3)(A). Whether the interest is properly allocable to investment property is a factual determination that must be made at the partnership level. See Terry v. Commissioner, T.C. Memo. 1984-442 (finding that the characterization of loss as ordinary or capital is a partnership item). Compare Estate of Quick v. Commissioner, 110 T.C. 172 (1998) (finding no partnership item in the characterization of a trade or business activity as active or passive because whether or not partners materially participated cannot be determined at partnership level).

Consistent settlement:

An indirect partner means a person holding an interest in a partnership through one or more pass-thru partners. I.R.C. §

6231(a)(10). The partners of [redacted] are indirect partners of [redacted]. You conclude that a consistent settlement must only be offered to the indirect partners of [redacted] through [redacted]. This conclusion is apparently based on your determination that two separate partnership items are at stake for two separate partnerships, 1) the amount of investment interest expense at the source partnership level, and 2) the characterization of that expense at the partner level. See Sente Investment Club Partnership v. Commissioner, 95 T.C. 243 (1990).

In fact, however, only one partnership item is at stake and it is a partnership item of the source partnership, [redacted], not [redacted]. For this reason, the same settlement terms must be offered to any other partner in [redacted], not just to its indirect partners through [redacted].

Conversion to non-partnership items:

Generally, the Service may elect to treat a partnership item as a non-partnership item if, subsequent to the filing of his original return, the partner has filed an AAR that would result in its treatment of the item being inconsistent with its treatment by the partnership. I.R.C. § 6231(b)(1)(A), (B).

If the Service had mailed a notice that the item would be treated as a non-partnership item, prior to the settlement, then it would not be necessary to offer a consistent settlement because no partnership items would be at issue.

In this case, however, the examiners chose to allow the administrative adjustment request, rather than to mail a notice that the item would be treated as a non-partnership item.

Because the item was a partnership item at the time the settlement was executed, the Service must offer a consistent settlement to all partners of the source partnership.

If you have any questions concerning this matter, please call Attorney Alice M. Harbutte at (303) 844-2214, ext. 224.

/s/
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